New Internal Control Guidance: What You Need to Know Now

Be sure you're addressing these important audit requirements.

By Richard A. Turpen

New audit rules that took effect at the end of 2009 mean that auditors will be taking a closer look at their clients' internal controls. The rules require auditors to communicate in writing any serious control problems they note during an audit. The regulations also establish more stringent thresholds for classifying these problems. As a result, organizations without extensive controls or oversight by a strong governing board can expect to receive a formal letter from their auditors.

The consequences of these letters can be severe. A nonprofit that's been informed of control issues risks losing credibility and funding. Therefore, it's essential that executives and directors understand key provisions in the new guidance and develop strategies to correct control problems in their organizations.

Understand the Rules

Under the new standard ("Communicating Internal Control Related Matters Identified in an Audit," Statement on Auditing Standards No. 115, also known as SAS 115), your auditors must evaluate any "deficiency in internal control" they observe while auditing your financial statements.[1] They'll write you a formal letter if they judge these deficiencies to be "material weaknesses" or "significant deficiencies." They'll consider a problem to be a "material weakness" if there's at least a reasonable possibility it could have led to a material misstatement in your financials. If they conclude otherwise, they'll ask themselves whether the deficiency is still so serious that your governing board ought to be informed of it. If their conclusion is yes, it's a "significant deficiency." If their answer is no, they aren't required to inform you of the condition but may choose to do so anyway.

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Many deficiencies, such as those that result in simple bookkeeping errors, are fairly routine. However, the standard takes a much broader view. For example, if a nonprofit has no employees with accounting knowledge, auditors are likely to regard this condition as a material weakness. The same is true of executive directors and board members. Auditors will be looking to see whether they have the accounting knowledge needed to perform a rigorous review of the financial statements, one that would spot errors or fraud.

If you get a letter from your auditors, it's meant for your internal use and may not be distributed to anyone outside your organization. However, an exception exists if you receive government assistance or are otherwise subject to regulatory oversight. In such cases, you may be required to furnish your auditor's letter to a governmental authority.

Clearly, receipt of this letter can put your funding in jeopardy. And even if you aren't required to provide your letter to outsiders, a knowledgeable donor or lender may ask whether you've received one and, if so, what concerns your auditor identified.

Take a Proactive Approach

If you don't address the new rules, you place your organization's future at risk. Fortunately, there are positive steps you can take to avoid problems. Your approach should be twofold:

1. Assess your internal controls.

Begin with the organizational environment. The most important internal control is the tone at the top. If your organization's leaders don't emphasize ethics and model ethical conduct, other controls won't matter.

Evaluate basic competencies. The core question in SAS 115 is whether you're capable of producing accurate financial statements. The answer depends on whether your accounting personnel and those who oversee them know when to seek guidance for non-routine transactions. Employees may not possess the expertise of a CPA, but can they recognize when they need to contact one?

Recognize "must-have" controls. Areas that are absolute musts in terms of internal control are fundraising, cash processing, asset safeguarding, and program spending. Contributors want assurance that their gifts are accurately tracked and protected, and they want to know that funds are used only for legitimate purposes. Therefore, you must be sure to do the following:

- Reconcile pledge accounts and other receivables with master balances. Submit any adjustments to management for review.
- Establish formal processes for receipting and disbursing cash.
- Perform timely independent bank reconciliations.
- Secure inventories, whether office supplies or items such as food maintained for distribution.

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• Require approval for all expenditures.

Segregate critical functions. A control often missing in smaller organizations is segregation of duties. At its most basic level, this concept means involving more than one person in a process. More formally, it is the separation of three crucial tasks so that no one person performs them all: authorizing transactions, recording those transactions, and maintaining custody of the assets. As an example, the employee who approves spending requests shouldn't be the same person who records purchases or maintains the bank account.

Step up management reviews. In smaller operations, segregating duties is difficult, and it's not uncommon for nonprofits to rely on a single employee to perform virtually all bookkeeping tasks. In these settings, closer supervision and managerial monitoring are essential.

Involve board members. A potential downside to increased manager presence—and one that your auditor is required to consider—is management override of internal controls. To mitigate this risk, you need to involve the board—for example, by arranging for bank statements to be mailed directly to a board member for review.

Don't forget the 990. The annual information return has taken on more significance since its revision in 2008 and now asks questions directly relevant to internal control.[2] How you answer these questions may reveal areas of concern to the auditor. In addition, your ability to prepare the new form accurately is a key audit consideration. Recordkeeping or compliance issues might raise doubts about that ability.

2. Work with your auditor.

Start by finding the right firm. Choose an auditor who has experience with nonprofits. As you talk with prospective firms, be certain they can explain their audit process to you. If the importance of controls isn't a big part of that discussion, keep looking.

Maintain a dialogue. Once the audit is under way, make yourself available as much as possible and ask that auditors do the same. Make it clear that you'd like progress updates. You don't want to hear about control problems at the last minute.

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Insist on specifics. SAS 115 requires only that auditors communicate serious control issues; it doesn't require them to discuss possible remedies. Nevertheless, a client-oriented firm will provide more than just a list of problems, and you should make clear that you expect more. For every weakness or deficiency your auditors identify in their letter to you, they should answer three questions—what the problem is, why it's a problem, and how to remedy it.

Seek guidance. Your auditors are internal control experts and can give you invaluable recommendations. While their code of ethics prevents them from establishing controls for you (because auditors are required to be independent of their clients), they're free to advise you and make suggestions. Be certain to discuss priorities with your auditors. If they identify several material weaknesses, for example, you may not be able to fix everything at once. So ask them to pinpoint areas you should address first.

Prepare a response. Deciding how, when, and whether to remedy control deficiencies involves tradeoffs, and those decisions are management's responsibility. SAS 115 notes that management may be required to prepare a written response to the auditor's letter. Even if not mandated, preparing such a document can be an excellent exercise, one that may educate board members about internal control and its importance. Moreover, it's an effective way to demonstrate commitment to accountability and strong governance.

Focus on What Matters

While directly applicable only to auditors, the new standard nonetheless puts pressure on nonprofits to improve their controls. Though many will find it a challenge to do so, the standard helps executives and boards focus on what matters most in their organizations.

Ultimately, internal control is about protecting resources so you can use them to achieve your organization's goals. If the new audit guidance stimulates discussion about risks your organization faces, it will be well worthwhile. ■

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Raising the Bar for Internal Controls

Many resources are available to help you strengthen internal control practices. The following may be particularly helpful:

Managing the Business Risk of Fraud: A Practical Guide (available at www.aicpa.org, www.theiia.org, or www.acfe.com).

Articles from previous issues of *Nonprofit World* (www.snpo.org/members), especially "Protecting Your Organization's Assets: A Primer on Internal Control" (Vol. 9, No. 2), "How to Find the Perfect Auditor" (Vol. 22, No. 3), "Fraud: Discovery and Action" (Vol. 25, No. 5), "Setting Up a Control System for Your Organization" (Vol. 16, No. 3), and "How to Conduct a Monthly Internal Financial Review" (Vol. 9, No. 6).

Footnotes

[1]SAS 115 was issued by the American Institute of Certified Public Accountants (AICPA, www.aicpa.org), the group responsible for establishing authoritative guidance for the audits of U.S. nonprofits and privately held companies. SAS 115 was circulated in October 2008 with early implementation permitted, so some nonprofits may already have experienced its effects. The new standard includes several useful sections, including a summary of internal control basics and an appendix with examples of internal control deficiencies.

[2]These questions are included in Part VI ("Governance, Management, and Disclosure") of the revised Form 990.